Sit Investment Associates

April 2019

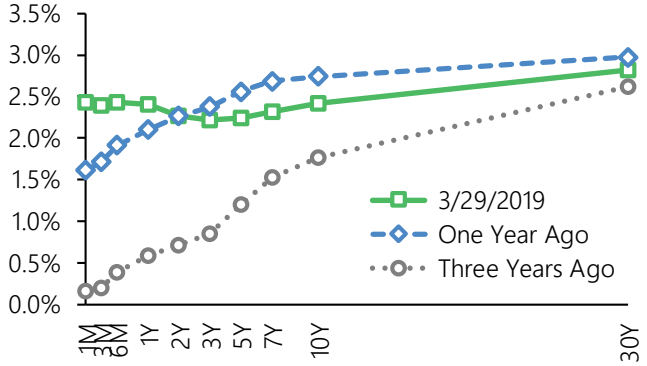
GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Inverted Yield Curve – Recession Signal or Noise?**
- ***Goldilocks* U.S. Economy: Solid GDP Growth and Benign Inflation**
- **Economic Green Shoots in China, But Scale of Recovery Still Unclear**
- **Curve Will Steepen as Economy Recovers from Recent Soft Patch**
- **U.S. Equities Remain Attractively Valued Relative to Fixed Income**

U.S. Yield Curve Reflects Confluence of Factors Rather Than Imminent Recession

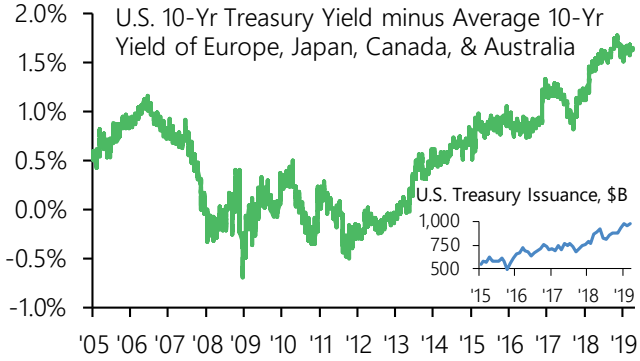
Yield Curve Distorted by Several Factors

U.S. Treasury Yield Curve



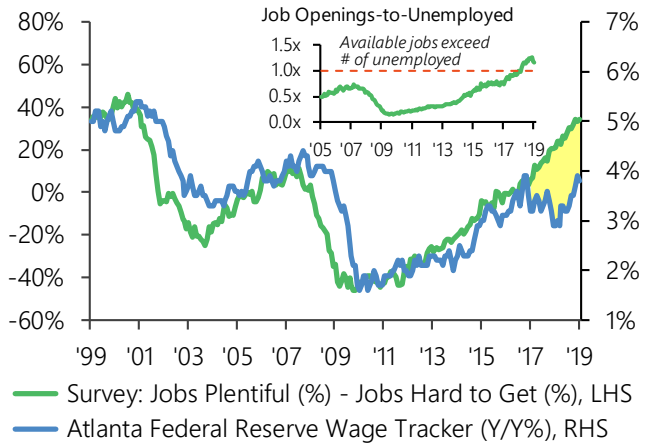
U.S. Rates Highest In Developed World

U.S. Treasury Yield vs Other Developed Markets

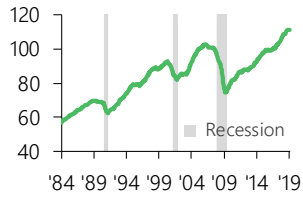


Current Yield Curve and Rising Expectations for Interest Rate Cuts at Odds with Economic Data

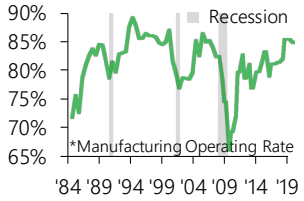
U.S. Job Availability and Wage Growth



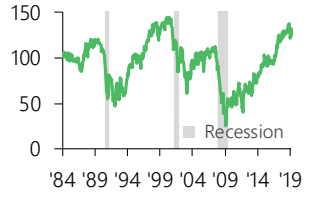
U.S. Leading Economic Index



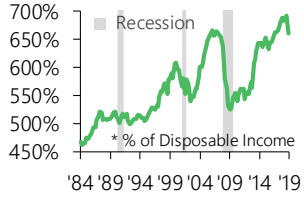
U.S. Capacity Utilization*



U.S. Consumer Confidence Index



U.S. Household Net Worth*



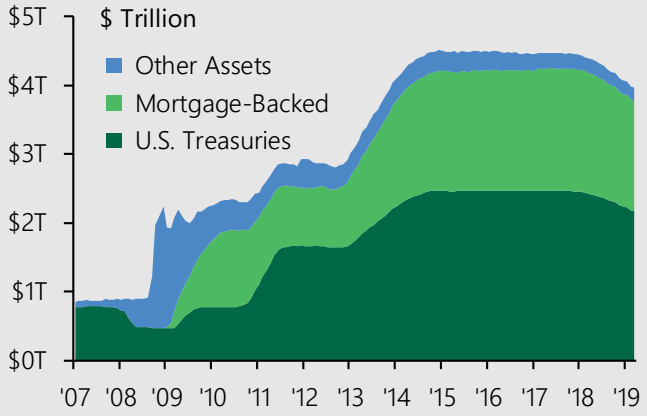
Source: FactSet, Evercore ISI, SIFMA, Conference Board, Institute for Supply Management, Bureau of Economic Analysis, Federal Reserve, 3/31/19

Inverted Yield Curve – Signal or Noise?

Financial markets received a surprise from Federal Reserve "doves" following the March meeting, with not only the announcement of ending balance sheet tapering by September, but also conveying they do not anticipate any additional interest rate increases in 2019. Investors anticipated the Federal Reserve would slow the pace of rate hikes and balance sheet reduction, but certainly not to the degree that it did. With most macroeconomic indicators still signaling healthy underlying U.S. growth, which Chair Powell highlighted at his press conference, many investors were left confused and wondering what concerned the Federal Reserve (Fed) so much that it would make such a dramatic shift in policy. Consequently, markets did not react as positively as they had when the Fed began making dovish moves in December. Stocks initially declined, and the U.S. Treasury yield curve became even more inverted, with T-Bills yielding more than 10-year Treasury bonds.

The Fed's balance sheet has come down from $4.5 trillion to $4.0 trillion and is expected to stabilize at $3.8 trillion in September. The balance sheet has been declining about $40 billion per month by not reinvesting all the funds from maturing Treasuries and principal/interest payments from mortgage securities. From May through September, the pace of decline will slow to about $30 billion per month. After September, the Federal Reserve will reinvest all maturity and mortgage payments into Treasuries.

Huge Fed Balance Sheet, Modest Decline



Source: U.S. Federal Reserve, 3/31/19

When reviewing the balance sheet, it is important to evaluate the level of excess reserves the Federal Reserve believes necessary. Current estimates have converged to a number close to $1 trillion, which is already very high. When the balance sheet unwind concludes in September, it will leave an estimated $1.3 trillion in excess reserves and a total balance sheet of $3.8 trillion. This higher-than-expected level of reserves has worried financial markets, as investors were left to wonder why the Fed feels the need to retain so much extra liquidity.

While the Fed left interest rates unchanged at the current target range of 2.25-2.50 percent, it changed its forecast from 1-2 hikes in 2019, to no hikes in 2019 and one hike in 2020. This sent a confusing message given that Mr. Powell has emphasized that underlying U.S. economic activity remains healthy, albeit slowing from a quicker pace. Weakness outside the U.S. impacted the Fed's view, including Brexit uncertainty that continues to weigh on Euro Area activity. In addition, tariff discussions, along with other factors, has slowed China growth rates. However, there is upside economic potential given the eventual resolution of these current overhangs. While global growth may have slowed from an above-trend pace, we believe economic activity is adjusting to a new equilibrium.

In the past when the yield on the 3-month T-bill was higher than that on 10-year Treasury bonds, many analysts have claimed that this inversion was a good predictor of recession. With this inversion again occurring, investors are fearing the worst. Yield curve inversions in and of themselves do not cause economic recessions. Many are the result of a deceleration in economic growth that causes investors to anticipate an interest rate cut. Various parts of the curve have experienced inversions over the past year, mainly driven by supply-demand imbalances in addition to the Fed's balance sheet reduction. Our view is that the yield curve will remain inverted in the near term and then begin to steepen. We anticipate the Treasury purchases will eventually be skewed to shorter durations, which will cause the front end of the curve to move lower. Additionally, the Fed is floating various ideas to have banks post short duration Treasuries as excess reserves at the central bank. This can accomplish two goals: first, increase demand for short term Treasuries (thus steepening the curve); second, reduce the cost to tax- payers of paying the banks interest on these excess reserves, currently over $30 billion a year. Furthermore, the Federal Reserve

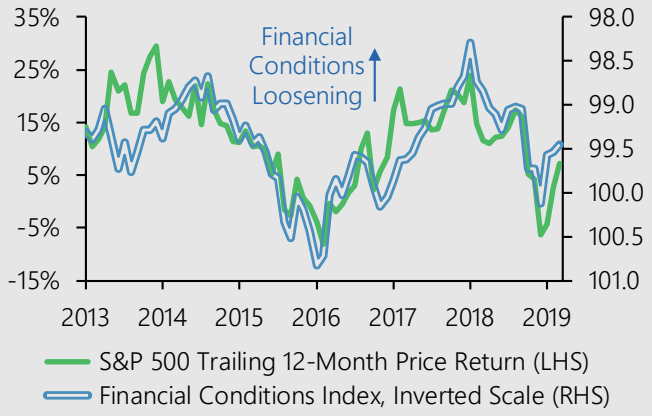
intends to let inflation run higher than 2 percent. The combination of falling short rates (due to increased demand) and higher long-term rates (as inflation is allowed to increase beyond 2 percent) will eventually cause the yield curve to steepen.

Given underlying U.S. economic strength and healthy consumer balance sheets, we are adding to credit and spread exposure via corporate bonds. TIPS are attractive as inflation expectations are currently too low relative to the level of economic activity. We are reducing Treasury exposure in the 8-10-year part of the curve after the recent rally in those tenors.

A deceleration this late in the economic cycle is bound to stoke recession fears, but a dovish Fed has led to improving financial conditions, boosting short-term economic prospects while supporting equity valuations. While we generally believe an "earnings-driven" market is healthy at this point in the cycle, it is also true that stock markets tend to perform well when the Fed is on hold. As the following chart indicates, the Fed "put" appears to be alive and well, with financial conditions improving markedly as rate expectations have been reigned in.

Improving Financial Conditions, Higher Stocks

S&P 500 Returns vs Financial Conditions

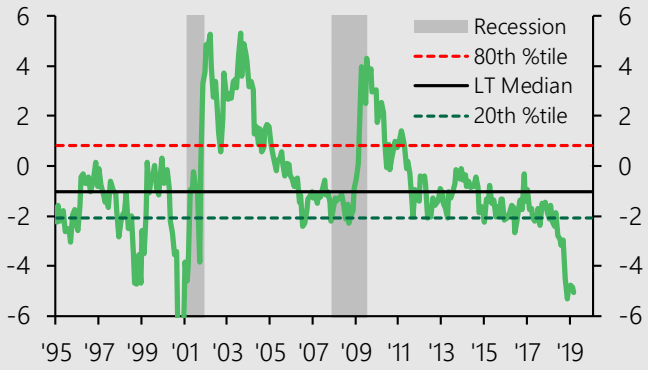


Source: FactSet, Goldman Sachs, 3/31/19

Falling yields and growth concerns tend to push investors toward defensive "bond proxy" sectors, and this time is no different. Valuations for defensive sectors (i.e., staples, utilities) have been rising for some time and are particularly elevated now. We believe the valuation disparity between many cyclical groups relative to defensive areas has simply gone too far.

Cyclicals Trading at a Significant Discount

S&P 500 Cyclical minus Defensive Price-to-Earnings Ratio



Source: ISI Evercore, 4/3/19

As discussed above, we do not believe the slight inversion of the yield curve is sending a "recession signal." Cyclical performance should improve as economic data stabilize and, particularly, as China stimulus begins to take hold. In addition, while "peak earnings" concerns are limiting investor enthusiasm for cyclicals, the Fed's dovish stance and improved financial conditions should give investors comfort that the end of this expansion is not imminent. Regarding investment strategy, we see compelling risk-reward opportunities in a diverse group of cyclicals, including aerospace, semiconductors, oil refiners, chemicals, airlines, life insurance, and investment banks. We do, however, remain cognizant of risks (e.g., failure of trade talks, Brexit, etc.) and believe it prudent to balance cyclicals with more stable, secular opportunity growth stocks. Attractive groups in this category include pharma/biotech, medical devices, HMOs, telecom, P&C insurance, and select technology stocks.

Financial markets frequently overshoot in both directions. Equity markets reflected too much pessimism at the end of 2018, and bond markets are doing the same now. More optimism on economic growth will, once again, reverse this sentiment. While market volatility has waned in recent months, we suspect it will not last too long.

The United States

U.S economy downshifting as domestic fiscal thrust fades & global growth decelerates near term, but benign inflation, rising productivity, and stimulus efforts abroad can extend cycle.

Growth Downshifting as Fiscal Stimulus Wanes, but There Is Still Gas in the Tank

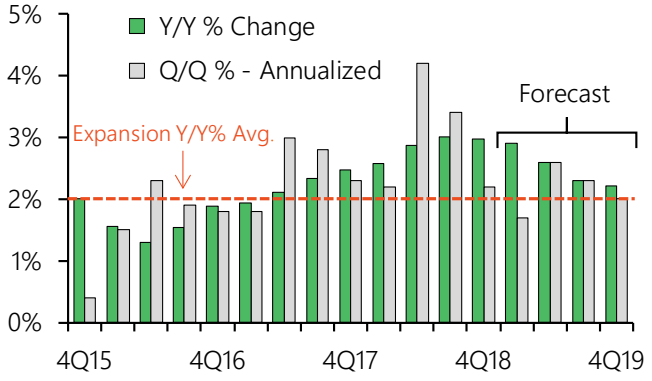
The sequence of easing financial conditions, synchronized global growth, capex upsurge, and unorthodox late-cycle fiscal stimulus underpinned a reacceleration in U.S. economic growth starting in mid-2016, with real GDP continually improving from a year-over-year pace of +1.3 percent in 2Q16 to +3.0 percent in 4Q18 (Exhibit 1). However, we project GDP growth will decelerate toward trend of +2.0 percent in 2019 as the direct impacts of fiscal stimulus wane. The U.S. is also not fully immune to the spillover effects of the global slowdown and is vulnerable to softer exports and inventory destocking near term. Nonetheless, reminiscent of the events that were harbingers of the 2016 resurgence in global growth, financial conditions are once again easing, the Federal Reserve has paused on rate hikes, and China is stimulating its economy. The combined fiscal thrust of the U.S., Euro Area, and China in 2019 is set to be the highest since 2009. A trade deal with China would also give an incremental boost to U.S. exports, tightening labor/capacity should spur additional capex, and wage gains continue to support consumer spending. Thus, absent an exogenous shock, we believe the U.S. expansion has more room to run.

The Only Thing We Have to Fear Is Fear Itself. Well, Fear and . . .

As highlighted in the opening *Special Topic*, the U.S. Treasury yield curve has historically inverted prior to recessions but can do so years beforehand (Exhibit 2). While the curve briefly inverted as financial markets priced in increased odds of rate cuts on slowdown fears, unconventional monetary policy, Treasury issuance, ultra-low foreign yields, and negative term premia have created distortions that muddy interpretation. Yet, we are careful not to dismiss recent bond market caution since declining confidence (rising fear) can trigger a self-fulfilling negative feedback loop. Other leading indicators largely imply U.S. GDP growth will continue to normalize but are not signaling recession. Notably, the Leading Economic Index, which has traditionally peaked an average of 16 months ahead of a downturn, continues to advance. Nonetheless, elevated policy uncertainty and decreased global trade have contributed to a slow patch in the U.S. economy. When

Exhibit 1: U.S. Real GDP Growth

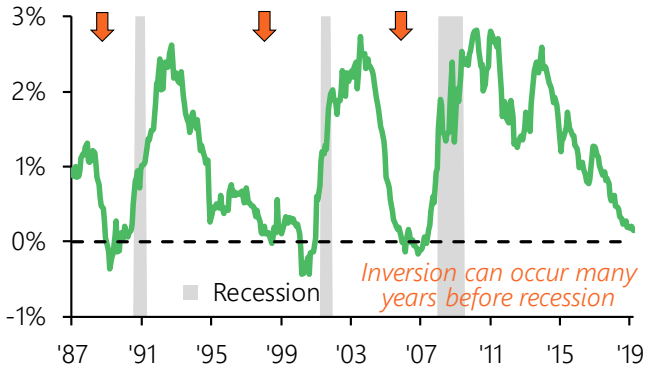
Chained 2012 Prices



Source: Bureau of Economic Analysis, Sit Investment Associates, 3/31/19

Exhibit 2: U.S. Treasury Spread

10-Year Bond Yield Minus 2-Year Bond Yield



Source: FactSet, 3/31/19

combined with the seasonal adjustment factor distortion, we forecast (headline) quarter-over-quarter, annualized GDP growth of +1.5 percent in 1Q19 (or +2.8 percent year over year), followed by a bounce to +2.3 percent in 2Q19. Risks include an escalation of the trade conflict, reacceleration in inflation, further Chinese softness, and a hard Brexit.

Improving Productivity Supporting Corporate Profits

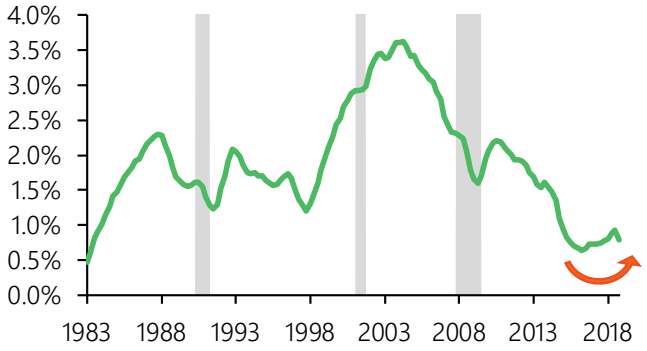
Tight labor markets continue to propel wage growth higher, with nominal average hourly wage growth now exceeding +3 percent year over year. Nonetheless, rising productivity growth is keeping unit labor costs contained and shielding corporate profitability, which received an additional boost from tax cuts (Exhibits 3 & 4). Increased capital spending is contributing to an improvement in output per hour and helping to increase the labor participation rate (technology is widening labor pool). Private sector spending on capital equipment grew +7 percent in 2018, with projections for a comparable increase in 2019. Improvements in the capital stock tend to lead productivity by 2-3 years, implying more productivity gains can be expected. Despite an unemployment rate of 3.8 percent, rising productivity and labor participation are helping to restrain inflation, extend the cycle, and boost GDP potential. Moderating international growth and a strong U.S. dollar have weighed on the earnings of U.S. multinationals in recent quarters. However, foreign growth headwinds should begin to dissipate in 2H19, with domestic profits bolstered by favorable policy, improving productivity, and solid macroeconomic underpinnings.

Debt Ceiling and Fiscal Spending Battle Looming; Risk of Another Shutdown

U.S. gross federal debt ballooned +49 percent to $22 trillion in 2018 from $15 trillion in 2008, with the Congressional Budget Office projecting a doubling to $30 trillion by 2028. Consequently, debt held by the public will increase 10 percentage points to 90 percent of GDP over the next decade. Reinstatement of the debt ceiling on March 2 capped the statutory debt limit at the current level of just over $22 trillion, forcing the U.S. Treasury to rely on "extraordinary measures" to avoid technical default – it is predicted that these actions will be exhausted by this September. Regardless of how brief, any default would likely lead to a debt rating downgrade and have a lasting negative impact on the economy and financial markets. While lawmakers will almost certainly do what they have always done – raise or suspend the limit – the stage is set for another standoff this autumn. We anticipate Congress will ultimately settle on a deal to increase slightly or hold current spending levels and pass a debt limit extension. However, an ever-rising debt load will hinder fiscal responses in the next recession and possibly crowd out private investment.

Exhibit 3: U.S. Productivity (Output per Hour)

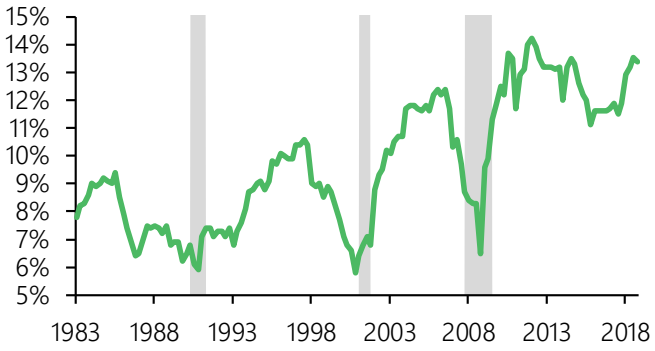
U.S. Productivity: Nonfarm Output per Hour
Five-Year Moving Average, Year-over-Year Percent



Source: Department of Labor, 3/31/19

Exhibit 4: U.S. Corporate Profit Margins

NIPA Corporate Profits After Tax
With IVA And CCAdj, SAAR

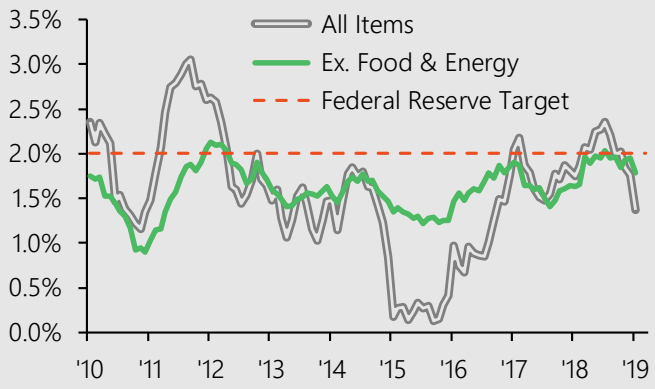


Source: Bureau of Economic Analysis, 3/31/19

United States: Notable Data Points

Benign Inflation Providing Monetary Flexibility

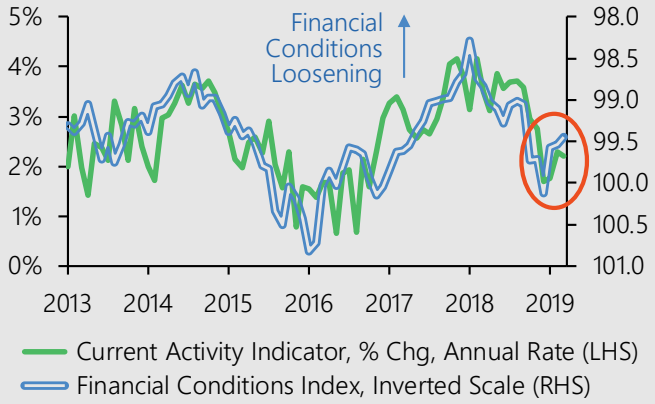
PCE Price Index
Y/Y Percent



Source: Bureau of Economic Analysis, 3/31/19

Easing Financial Conditions Bode Well for GDP

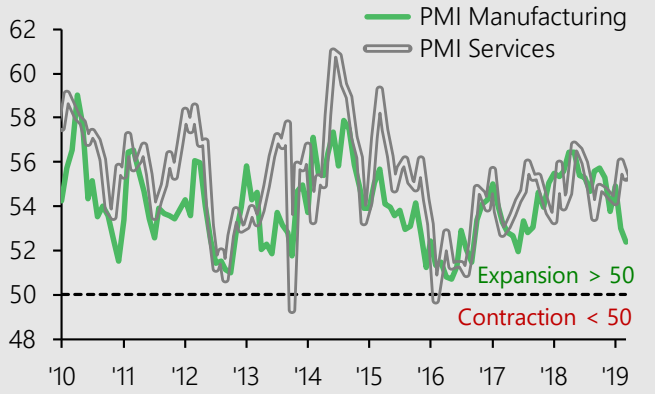
U.S. Current Economic Activity vs Financial Conditions



Source: Goldman Sachs, 3/31/19

PMI Data Indicative of Solid Growth Prospects

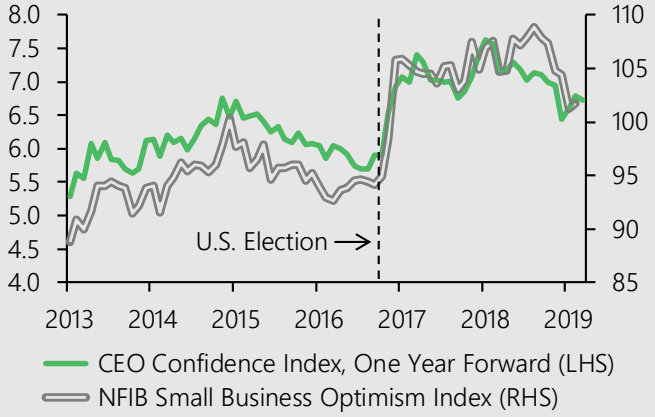
IHS Markit Purchasing Managers' Index
United States



Source: IHS Markit, 4/3/19

Business Optimism Off 2018 Peak, But Elevated

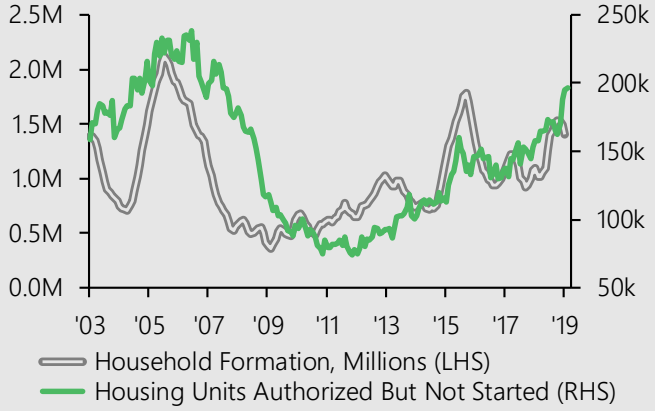
U.S. Business Confidence



Source: Chief Executive Magazine, NFIB, 3/31/19

Strong Household Formation Driving Housing

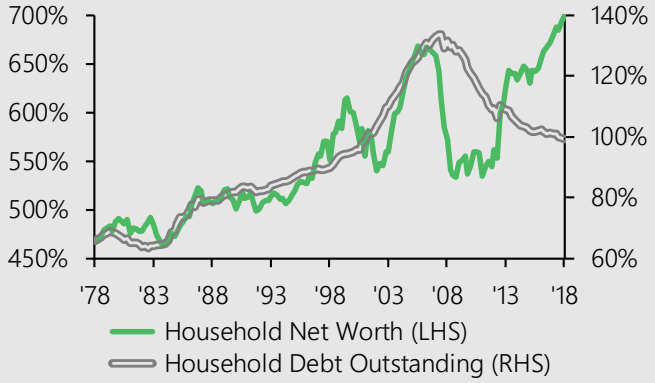
U.S. Household Formation vs Housing Units Authorized



Source: U.S. Census, 3/31/19

Household Balance Sheets in Great Shape

U.S. Household Net Worth and Debt Outstanding
Percent of Disposable Income



Source: Bureau of Economic Analysis, Federal Reserve, 3/31/19

Europe

Soft export growth and ongoing policy uncertainty continue to overshadow resilient domestic demand. A positive Brexit resolution and Chinese recovery would be a boon to the region.

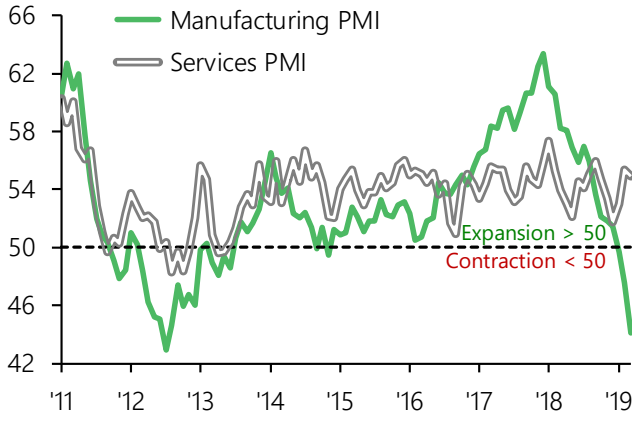
Glimmers of Hope for 2H19, but Euro Area at the Mercy of External Forces

The confluence of slowing global trade, persistent political/trade policy uncertainty, and exceptional events (i.e., new car emissions standards, protest-related disruptions, etc.) is weighing on Euro Area economic growth, with real GDP now projected to grow about +1.2 percent in 2019 versus the five-year annualized pace of +1.9 percent. Contraction of Germany's trade-sensitive industrial sector has been particularly notable, as a slump in new export orders and softer car demand pushed the manufacturing PMI to a 80-month low in March (Exhibit 5). Key macro risks include U.S. tariffs on car imports, a no-deal Brexit, and a China hard landing. Absent an external shock, however, GDP growth is poised to improve in 2H19. Consumer spending remains resilient, driven by tightening labor markets, rising wages, and favorable credit. Car sales also appear to be normalizing post a swing in demand caused by new emissions criteria. Moreover, while we expect a more modest pass-through of China stimulus to global trade versus 2016, stabilization of China's economy bodes well for exports and the durability of the recovery. Finally, fiscal policy is set to become the most expansionary it has been in nearly a decade (Exhibit 6).

Brexit – The Dark Cloud That Hangs Over Europe

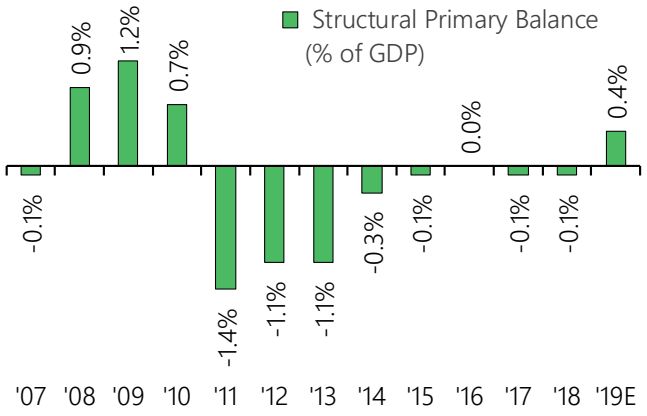
The clouds of uncertainty tied to Brexit, trade policy, and global growth also hang over the UK economy, dampening both capital investment and exports. Economic growth is buoyed by consumer expenditures, which are now growing largely in line with underlying employment and wage gains. Household savings has stabilized slightly above 4 percent but remain well below historical levels as consumers dipped into savings post a hit to real incomes from higher inflation. A continued drop in confidence, notably in the event of a no-deal Brexit, may precipitate a preference for savings over spending and push the economy into recession. Therefore, our projection for real GDP growth of +1.5 percent in 2019 is largely contingent on approval of the Withdrawal Agreement. Having already rejected the agreement three times, the UK parliament now has until April 12 to approve the existing deal, offer another plan, or exit the European Union immediately without a treaty. While a soft (or no) Brexit deal would provide a better economic outcome, counter-cyclical stimulus will likely be engaged to soften the blow of a no-deal Brexit.

Exhibit 5: Germany Purchasing Managers' Index



Source: IHS Markit, 4/1/2019

Exhibit 6: Euro Area Fiscal Stimulus

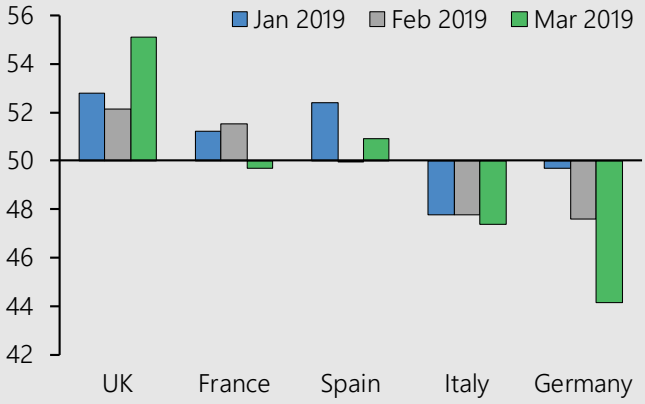


Source: European Commission, 3/31/19

Europe: Notable Data Points

Germany Hit Hard by Slowing Global Trade

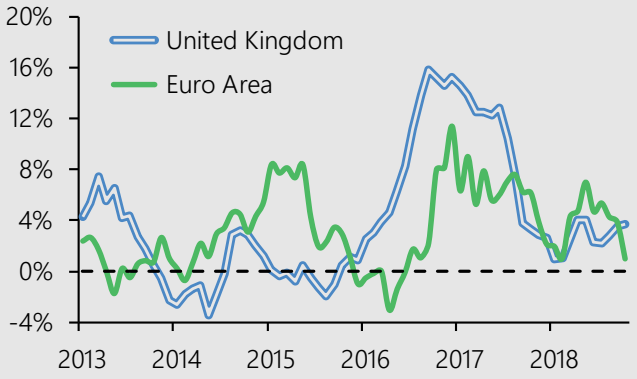
Manufacturing Purchasing Managers' Index



Source: IHS Markit, 4/4/19

Euro Area Exports Remain Under Pressure

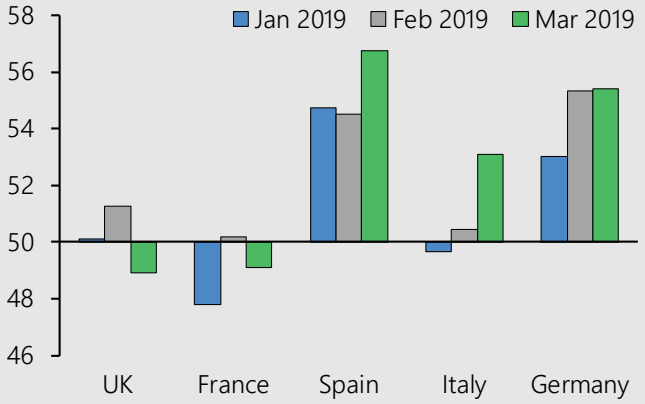
Export Growth
Y/Y Percent, 3MMA



Source: Eurostat, Office for National Statistics, 3/31/19

Germany Services Almost a Mirror Image

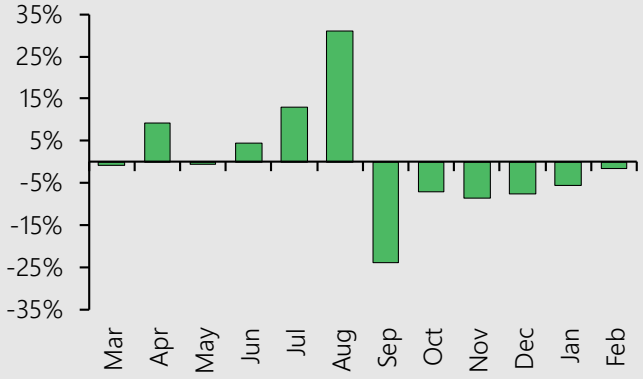
Services Purchasing Managers' Index



Source: IHS Markit, 4/4/19

Car Demand Stabilizing Post Emissions Change

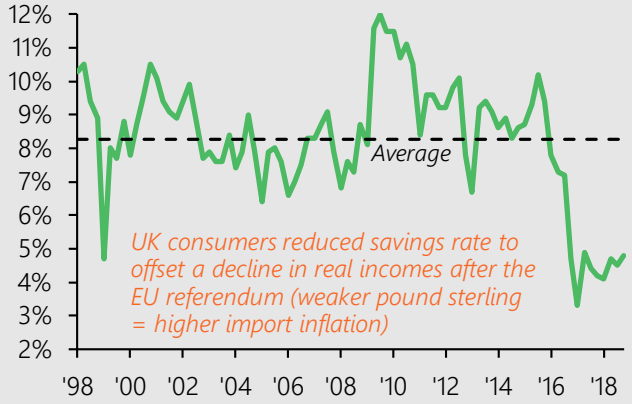
Euro Area New Car Registrations
Y/Y Percent



Source: European Automobile Manufacturers Association, 3/31/19

UK Savings Reduced to Support Spending

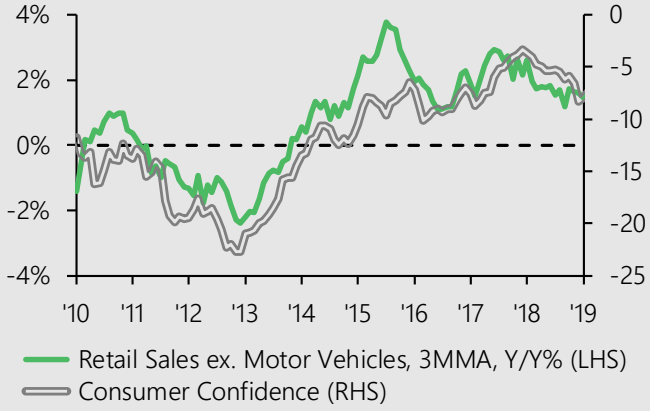
UK Household Savings Rate (%)



Source: Office for National Statistics, 3/31/19

Euro Area Retail Sales Remain Resilient

Euro Area Retail Sales vs Consumer Confidence



Source: Eurostat, 3/31/19

Japan

We remain downbeat on Japan's economic growth prospects as emerging signs suggest the slowdown abroad is spreading to the domestic economy.

We expect Japan real GDP to grow +0.5 percent in 2019 as slowing growth abroad weighs on its export-driven economy. The export decline that began late in 2018 has accelerated further, pulled lower by weakening demand from China. Manufacturing activity has downshifted as a result with industrial production slumping and machinery orders contracting. Nonetheless, the domestic economy remains resilient by comparison as consumption continues to grow modestly and unemployment stands at multi-year lows. Yet, there are emerging signs external weakness may begin to dampen domestic strength. Early indications from spring wage negotiations suggest slower wage gains ahead as firms become cautious amid the uncertain outlook. Consumer confidence, already fading, has also extended its decline. A bottoming in growth abroad later in the year, be it from a U.S.-China trade agreement or an improved outlook in China, would clearly be a welcomed development and support for exports. However, we remain watchful for further signs that the damage to domestic demand may already be done. Limited flexibility to ease monetary policy farther and a consumption tax hike taking effect in October further compound our concerns.

Emerging Markets

Stimulus measures have led to signs of stabilization in the Chinese economy. Moderating global growth combined with political uncertainty remain key concerns for Brazil and Mexico.

China's Economy Likely to Bottom Soon, but Only Modest Recovery Expected

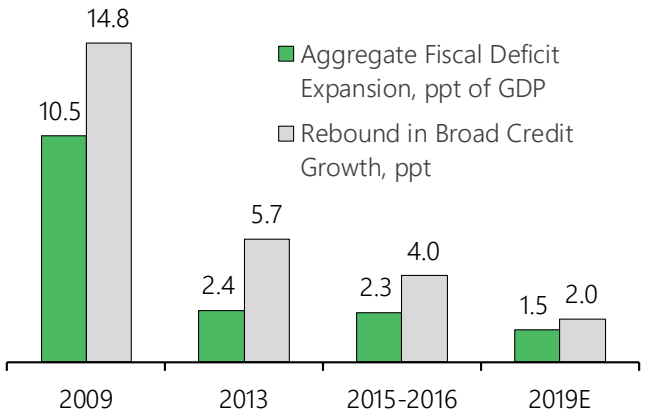
We are now incrementally more positive on China's growth prospects as macro data year to date has been better than feared, providing early signs of economic recovery. Looking forward, we anticipate real GDP growth will bottom in the second or third quarter of 2019. However, despite stimulus measures, we expect only a modest economic rebound for a couple of reasons. First, monetary stimulus thus far has been smaller than previous rounds and its impact on the economy is becoming less effective (Exhibit 7). Second, larger-than-expected tax cuts have boosted business sentiment, but it remains to be seen when and to what degree this will lift the broader economy (Exhibit 8). Most macro datapoints remain weak, with some green shoots appearing just recently. Latest surveyed urban unemployment is at the highest since March 2017, lower prices are still pressuring industrial profits, and real estate investment could rollover given weak leading indicators. Encouragingly, both credit growth and new PMI orders are showing signs of strength. We expect policymakers to be data dependent on whether to implement more stimulus, which could include further reserve requirement ratio reductions, interest rate cuts, and/or potential loosening in property policy.

Sticking Points Remain, but a U.S.-China Trade Deal Is Likely

U.S.-China trade negotiations have been progressing better than expected since late last year, with an open-ended delay in the previously proposed March 1 step-up in U.S. tariff rates on Chinese goods from +10 percent to +25 percent. Though some sticking points remain, we expect some type of trade agreement in the months ahead (Exhibit 9). We also believe China should seize trade negotiations as an opportunity to reinforce pro-market reform and remain cautiously optimistic about the potential for positive surprises versus current market expectations. Partly in response to the trade dispute, China has taken steps in the past year to open its economy further. There has also been some

progress on competitive neutrality and intellectual property protection, such as the fast-tracked passage of new foreign investment law recently. However, more needs to be done and implementation remains key, not only to address U.S. demands, but also to benefit its own economic development.

Exhibit 7: China – Current vs Past Easing Cycles



Source: Morgan Stanley, 3/15/19

Exhibit 8: Bigger Than Expected Tax Cuts

	Effective date	Estimated savings
Value Added Tax will be cut to 13% from 16% for the manufacturing industries Value Added Tax will be cut to 9% from 10% for the transportation and construction industries	Apr. 1st, 2019	~RMB800 bn
Firm's pension payment ratio will be cut to 16% from 18-20% currently	May 1st, 2019	~RMB360 bn

Source: Bloomberg, Morgan Stanley, Sit Investment Associates, 3/31/19

Exhibit 9: Break Down of U.S.-China Trade Negotiations

	U.S. Demands	China Offerings/Demands
Trade	**More balanced trade:** Reduce its trade surplus with the U.S. substantially	**Buy more:** China will increase imports from the U.S. by $1 trillion over next six years; annual imports will increase from $150 bn to $600 bn
Trade	**Fairer trade:** Reduce tariffs in 'non-critical' sectors to levels that are not higher than the levels of U.S. tariffs	**Reduce tariffs:** China reduced average most-favored national (MFN) tariff rates from 9.8% to 7.5% in 2018 (effective Nov. 1). Lower import duties but not to match those U.S.
Trade		**Tariffs:** U.S. should remove existing penality tariffs on Chinese imports
Structural Issues	**Stop IP theft**: Stop policies that compel technology transfers and stop government-backed cyber theft of intellectual property	**IP protection**: China revised the Patent Law in late 2018 to improve the protection of intellectual property. China revised Foreign Investment Law in March 2019, emphasizing pre-entry national treatment, negative list approach, relaxed JV requirement and no forced technology transfer
Structural Issues	**Open up**: Ease restrictions on foreign investment by revising the so-call 'negative list'	**Open(ing) up:** Loosen restrictions on financial services, including ratings company, credit card services and a removal of JV requirements for security firms in 3 years. Remove JV requirements in the auto sector for new business and after years for existing.
Structural Issues	**End government subsidies:** End government subsidies, including to industries targeted by Made in China 2025 plan	**Competitive neutrality principle:** Foreign companies will have equal access to government projects and industry subsidy. Remove or reduce subsidy in solar energy, new energy vehicles, etc.
Structural Issues	**Currency regime**: No competitive devaluation	**Currency regime**: Increase CNY flexibility. Follow G20 principles of no competitive devaluation.
Enforcement	**Do not resist:** U.S. can re-impose tariffs if China fails to deliver on its commitment; China should cease retaliatory actions for U.S. restrictions on China's investment in sensitive U.S. sectors	**Fair agreement:** Trade agreement should be fair to both sides. Tariff should not be used as a negotiation weapon. The objective is to remove all existing tariffs.
Enforcement	**Regular monitoring & communication**: Monthly at working level; quarterly at vice minister level; semi-annually at minister level	

Source: JP Morgan, 3/26/19

India's GDP Growth Remains Strong; Expect Positive Election Outcome

We project India's real GDP will expand +7.0 percent in fiscal 2019 and +7.2 percent in fiscal 2020, on higher spending and investment. Following the ruling Bhartiya Janata Party (BJP) electoral loss in three key states last year, the Indian government is expected to spend 1.8 trillion rupees ($25 billion) in populist measures and tax cuts to win the votes of farmers and the urban middle-class in upcoming general elections starting on April 11. While GDP growth was softer than expected last quarter, key macro indicators including a solid manufacturing PMI reading of 52.6 in March, rising oil consumption, and an acceleration in bank credit growth point to underlying economic strength. To further stimulate economic growth, the Reserve Bank of India cut interest rates -25 basis points to 6.25 percent in February and expects another rate cut at its April meeting, as February's inflation of +2.6 percent remains below the central bank's target. Finally, election risks are receding as Prime Minister Narendra Modi's BJP is expected to win re-election. Polls expect the National Democratic Alliance (the BJP and Allies) to have a majority, allowing it to continue its pro-growth economic policies.

South Korea's Growth Sluggish; Geopolitical Risk Rises with No Agreement

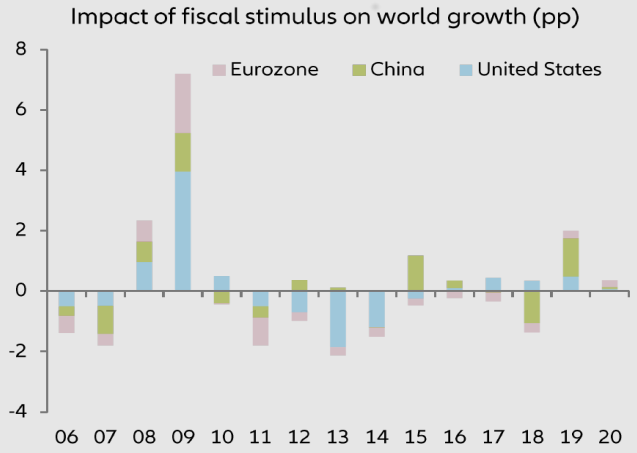
South Korean real GDP growth will likely downtick modestly to around +2.5 percent in 2019 from +2.7 percent in 2018, as sluggish export demand, inventory destocking, and moderating consumer spending counter expansionary fiscal policy. Nonetheless, South Korea should be a key beneficiary of improving Chinese growth prospects, as China is a major importer of South Korea's electronics, automobiles, petroleum, and ships. On the domestic front, President Moon Jae-in continues to pursue an economic policy agenda to include higher wages, tighter restrictions on working hours, greater welfare spending, and higher taxes. However, these policies have resulted in slower economic growth and higher unemployment. The Bank of Korea kept the base rate at 1.75 percent during the quarter and we expect rate cuts to stimulate growth, as inflation is below the central bank's target of +2.0 percent. On the geopolitical front, President Trump and Chairman Kim Jong-un concluded their second summit in Vietnam without any official agreement on denuclearization. Although North Korea has threatened to suspend denuclearization talks with the U.S. and to restart missile tests, we are optimistic on a peaceful resolution.

Brazil's Economic Growth Dependent on Reform; Mexico's Economy Slowing

Brazil's economy is gradually recovering from an 18-month-long recession that ended in late 2016, with growth prospects lifting modestly despite ongoing fiscal austerity and moderating global trade. We currently project real GDP will grow about +2.0 percent in 2019 versus +1.1 percent in 2018, buoyed by consumer spending and private investment. However, success of the new president's ambitious agenda – including pension reform, asset sales/privatization, tax system overhaul, and bilateral trade initiatives – is vital for both fiscal stability and sustainability of the current economic expansion. President Jair Bolsonaro's draft of pension reform, with savings of 1.2 trillion reais ($320 billion or 16 percent of Brazil GDP) in 10 years, will likely be revised down in Congress given current political polarization. Moreover, the recent arrest of President Michel Temer may delay passage of the bill, as politicians focus on the possible spread of corruption charges. Regarding monetary policy, we expect the Central Bank of Brazil to cut interest rates from +6.5 percent to support growth, as inflation has fallen below the target of +4.25 percent. In Mexico, we project GDP growth to slow to +1.8 percent in 2019 from +2.0 percent in 2018. Consumption continues to grow but at a slow pace. Fixed investment may also remain weak because of uncertainty over Mexico President Andres Manuel Lopez Obrador's socialist policies. We do not expect Banco de Mexico to cut interest rates as inflation of +3.94 percent is still above target.

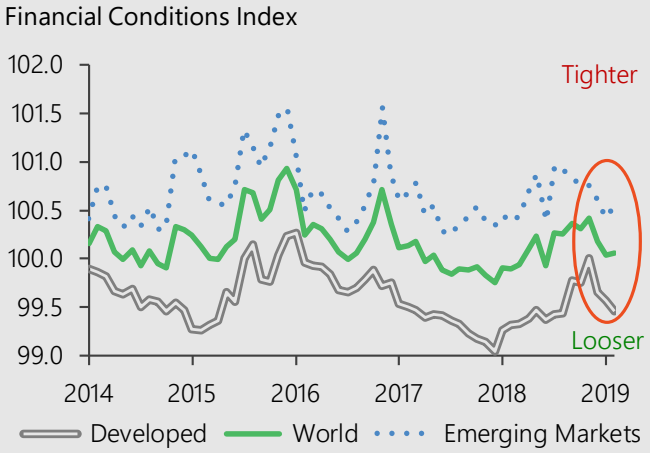
Emerging Markets: Notable Data Points

Highest Combined Fiscal Stimulus Since 2009



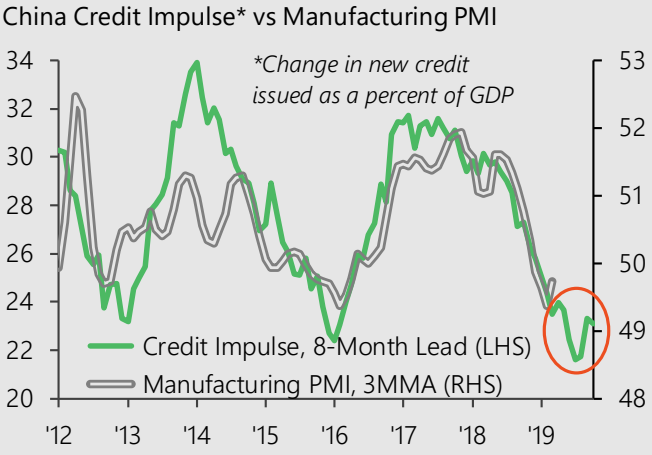
Source: Euler Hermes, 3/22/19

Global Financial Conditions Easing Again



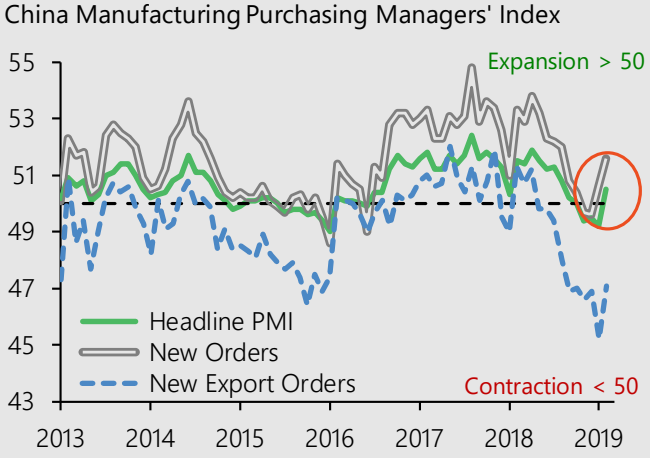
Source: Goldman Sachs, 4/5/19

China Credit Impulse May Be Bottoming



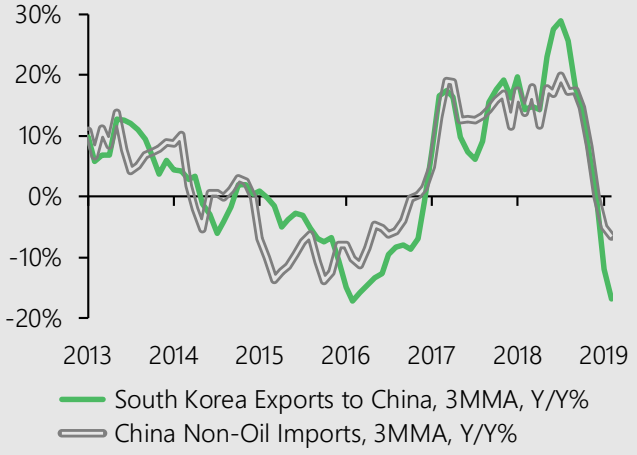
Source: Bloomberg, National Bureau of Statistics, 4/3/19

Better-Than-Seasonal Rebound in China PMI



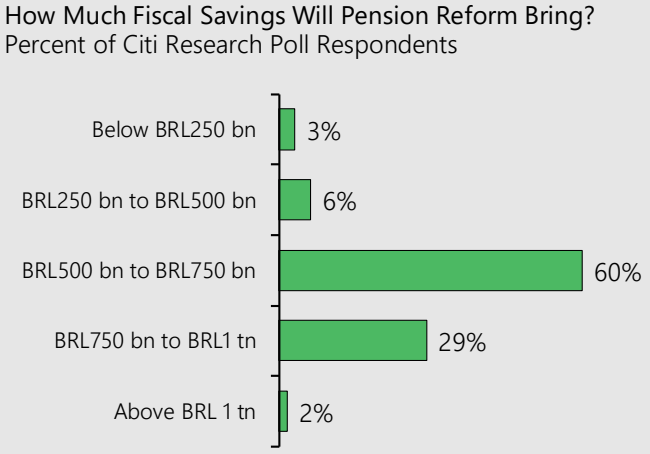
Source: National Bureau of Statistics, 4/4/19

South Korean Exports to China Remain Weak



Source: International Trade Association Korea, China Customs, 3/31/19

Muted Investor Expectations for Brazil Reform



Source: Citi Research, 3/28/19

Taxable Bonds

Dovish Reversal at the Fed

On several fronts, the first quarter of 2019 was generally a reversal of the fourth quarter of 2018. Credit spreads retraced previous widening, oil prices increased +30 percent, and equity markets rallied. It is curious, with this backdrop, why the Federal Reserve announced quite a significant shift in monetary policy. The balance sheet reduction program, which was to continue on "autopilot" at the December meeting, will now come to its conclusion in October of this year. Additionally, any future increases in interest rates are on hold for at least the remainder of 2019, a marked difference from previous guidance of 1-2 increases. The result of these changes sparked a rally in the Treasury market, in such a way as to invert the yield curve. The yield on the 3-month T-bill is now higher than the 10-year Treasury. When this happens, investors start talking recession. Nevertheless, underlying economic activity remains healthy, albeit moderating from a near-record pace. The unemployment rate is at an historic low and wages are increasing. Potential downside risks are generally at the global level to include Brexit-related uncertainty, slowing growth in China, and tariff discussions. Please see our *Special Topic* section at the beginning of this paper for a further discussion.

Fed Balance Sheet – the Devil Is in the Details

The Federal Reserve (Fed) currently holds roughly $2.2 trillion in Treasury securities that are rolling off at a maximum rate of $30 billion per month. In May 2019, the amount of reduction will be capped at $15 billion per month, and in October, the roll-off will cease altogether and the Fed will again be reinvesting the proceeds of maturing Treasuries to hold the size of the balance sheet constant. The mortgage holdings, of which the Fed currently holds approximately $1.6 trillion, is currently rolling off at a maximum rate of $20 billion per month. Essentially there is no change to the mortgage roll off. However, coinciding with the end of overall balance sheet reduction, the Fed will begin investing any mortgage payments received, up to the $20 billion cap, in Treasuries, thus shifting the composition of the balance sheet to only Treasuries. Importantly, the Fed stated that the composition of Treasury purchases will be made across maturities to roughly match the maturity composition of outstanding Treasuries. This anticipated increase in demand drove the strong rally in bonds, particularly in maturities from 2 to 10 years.

Taxable Fixed Income Outlook and Strategy

Given the recent rally in the bond market, we favor reducing exposure to Treasuries in the 8- to 10-year part of the yield curve. We believe the Fed is highly motivated to steepen the curve by increasing demand on the short end, while letting the long end drift higher with inflation. TIPS still look attractive, as we believe inflation expectations are understated. Domestic economic activity, while moderating, will continue to be positive. Two-thirds of GDP is driven by the consumer, and we see no signs of stress on the horizon. Consumer balance sheets are healthy, with a savings rate around 6 percent and a household debt service ratio near 10 percent. Wages are increasing and there are now more available job openings than there are unemployed people to fill them. With wage and job stability, household formation is also improving. As such, we favor credit and spread risk, and will add to corporate bonds when appropriate.

Municipal Bonds

Tax-Exempt Yields Decreased Markedly and the Yield Curve Flattened

Tax-exempt municipal bond yields, as measured by the Municipal Market Data (MMD) AAA GO curve, ended the quarter substantially lower. As shown in Exhibit 10, 10-year and 30-year AAA GO spot yields each decreased 42 basis points, to 1.86 percent and 2.60 percent, respectively. Shorter tax-exempts also decreased markedly. Specifically, 5-year and 10-year AAA GO spot yields decreased by 29 and 37 basis points each, to 1.49 percent and 1.57 percent, respectively. The municipal curve flattened during the quarter to a spread of 111 basis points between 2-year and 30-year AAA GO yields versus a spread of 124 basis points at the end of 2018 (Exhibit 11). The yield decrease for municipals was larger than comparable Treasuries across the curve, resulting in richer MMD to U.S. Treasury ratios. Notably, long municipals no longer appear cheap relative to Treasury yields, joining the rest of the tax-exempt yield curve. The Bond-Buyer 40-Bond Index, predominantly consisting of longer bonds, fell 23 basis points during the quarter to a yield of 3.86 percent.

Duration Drives Performance; Record Fund Flows

Longer bonds outperformed shorter bonds and were the most significant driver of tax-exempt performance during the quarter (Exhibit 12). In terms of other trends, lower credit quality bonds outperformed higher quality bonds and revenue bonds outperformed general obligation bonds. Not surprisingly given the credit quality relationship, lower quality revenue bond sectors, e.g. tobacco and healthcare, had the strongest performance in terms of specific revenue bond sectors. More broadly, insured bonds had stronger performance than any specific revenue bond sector. Tax-exempt closed end funds had tremendous performance during the quarter, with the universe up over 8 percent. In terms of fund flows, tax-exempt funds had the strongest start to the year since record-keeping started in 1992 (Exhibit 13). Lipper data reflects over $22 billion going into tax-exempt funds so far this year. Year-to-date municipal issuance, slightly higher than $75 billion through March, is tracking modestly higher than the $65 billion of issuance in the first quarter of last year (Exhibit 14).

Tax-Exempt Fixed Income Outlook and Strategy

We are less certain regarding the outlook for both overall interest rates and those on tax-exempts going forward. The more dovish tone from the Fed has already contributed to a substantial rally in rates and seems likely to contain the absolute level of interest rates over the near-term. On the other hand, if inflation accelerates from current levels or global GDP growth firms, we could see a rapid change in sentiment leading to an increase in interest rates. Modifying this outlook for tax-exempts, although positive fund flows and demand in general have been able to absorb easily municipal supply, tax-exempt fund flows can reverse course rapidly. While the pace of supply does not appear likely to markedly increase, should fund flows turn meaningfully negative for a sustained period, tax-exempt rates would increase relative to Treasuries. Sit intermediate and long duration portfolios continue to utilize a barbell strategy, containing a combination of bonds with short call features and longer duration bonds with attractive yields relative to both duration and credit quality. All portfolios continue to provide meaningful current income, which has been shown to be the primary driver of total return over a full market cycle. We expect to maintain most portfolio durations near their current levels and, as always, view diversification as a key tenet in managing portfolio credit risk.

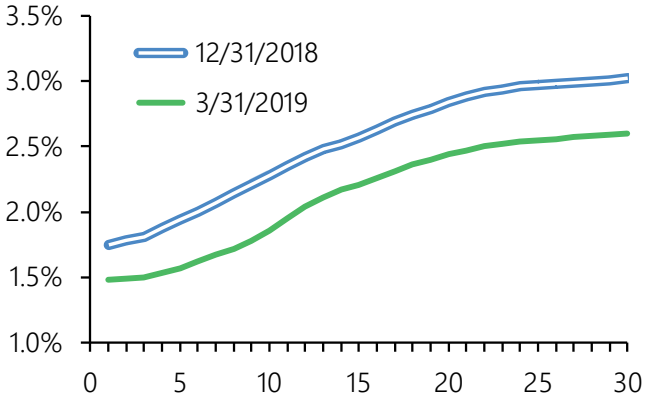
Exhibit 10: Municipal Yields and Spreads

Yields	12/31/18	3/31/19
2-Yr MMD AAA GO	1.78	1.49
5-Yr MMD AAA GO	1.94	1.57
10-Yr MMD AAA GO	2.28	1.86
30-Yr MMD AAA GO	3.02	2.60
2-10 MMD Spread	0.50	0.37
10-30 MMD Spread	0.74	0.74
2-30 MMD Spread	1.24	1.11
Bond Buyer 40 YTM	4.09	3.86

Source: Thomson Reuters, The Bond Buyer, 4/1/2019

Exhibit 11: Municipal GO Yield Curve

Municipal Market Data (MMD) AAA GO Yield Curve



Source: Thomson Reuters, 4/1/2019

Exhibit 12: Municipal Bond Index Returns

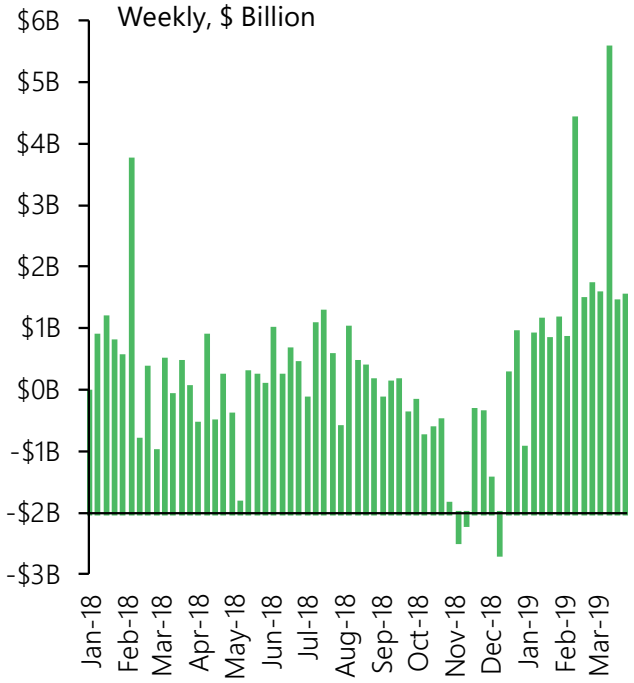
Bloomberg Barclays Municipal Bond Index Returns

Percent

	1Q19		1Q19
Muni Bond Index	2.90	GO Bond Index	2.78
3-Year	1.33	Revenue Bond Index	3.07
5-Year	2.11	Electric	2.70
7-Year	2.69	Hospital	3.28
10-Year	3.15	Housing	2.74
Long	3.85	IDR/PCR	3.19
		Tranportation	3.12
AAA	2.67	Education	3.11
AA	2.74	Water & Sewer	2.80
A	3.13	Resource Recovery	1.78
BAA	3.59	Leasing	3.16
		Special Tax	3.12
		Tobacco Index	3.48
		Insured Bond Index	3.91

Source: Bloomberg, 4/1/19

Exhibit 13: Municipal Bond Fund Flows



Source: Thomson Reuters, 4/1/2019

Exhibit 14: Municipal Bond Issuance, $ Million

	2017	2018	2019
Jan	$36,048	$21,506	$24,671
Feb	$23,385	$17,895	$26,102
Mar	$32,894	$26,084	$24,254
1Q Total	$92,326	$65,485	$75,027

Source: The Bond Buyer, 4/1/2019

The Federal Reserve Doves Put T.I.N.A. Back in Play

With a year-to-date return of +13.6 percent, the S&P 500 Index ended the quarter just 3.3 percent shy of the all-time high of 2,931. All eleven S&P sectors participated in the strongest one-quarter rally since 2009, with notable strength in technology, real estate, and industrials. The S&P 500 forward price-to-earnings ratio now stands at 17.1 times, slightly above its long-term average of 15.1 times and below its cycle high of 19.5 times. While multiple expansion is not our base case, fund flows into equities from bonds may push valuations even higher. With bond yields receding on dovish monetary policy, the 10-year Treasury yield of 2.41 percent on March 31 pales in comparison to the 5.83 percent earnings yield of the S&P 500. As has been the case for much of the current equity bull market, "**t**here **i**s **n**o **a**lternative" (i.e., a dearth of investment vehicles other than equities offering attractive returns) may once again push investors out on the risk curve. Although Treasury yields have been distorted by several factors, inversion of the yield curve has not historically been a death knell for equities. After the spread between 10-year and 2-year Treasury yields initially turned negative in recent cycles, the S&P 500 generated returns of +41 percent before peaking in 2000 and +29 percent in 2007.

U.S. corporate profit growth is expected to decelerate in the near term against extremely difficult year-over-year comparisons (Exhibit 15). Specifically, bottom-up earnings per share for the S&P 500 Index are projected to increase +4.2 percent in 2019 versus +22.1 percent in 2018 (boosted by tax cuts) and an annualized pace of +4.6 percent between 2012 and 2017 (Exhibit 15). Margin expansion has been key to profitability in this cycle, driving nearly 60 percent of S&P 500 earnings growth. The S&P 500 operating margin grew to +12.1 percent in 3Q18 from +4.6 percent in in 3Q09, before falling back to +10.1 percent in 4Q18. Much of the 4Q18 contraction was due to the equity market pullback and its negative impact on financial sector margins. In addition, since over 40 percent of S&P 500 sales are generated overseas, profits of multinationals have been dampened by the strong U.S. dollar and slowing global trade. While additional margin expansion will prove difficult going forward, S&P 500 margins are poised to improve from 4Q18 levels as the financial sector is recovering on a better outlook for trading, IPOs, asset management, and mortgage activity. A recovery in global trade, weaker U.S. dollar, and improving productivity will also likely aid multinationals as the year proceeds.

Exhibit 15: S&P 500 Bottom-Up Earning per Share, Y/Y Percent

S&P 500 Sectors	2012	2013	2014	2015	2016	2017	2018	2019E	2020E
Consumer Discretionary	8.2%	16.8%	2.6%	5.1%	12.8%	-1.2%	20.1%	7.8%	14.0%
Consumer Staples	4.0%	8.3%	4.5%	-2.4%	3.3%	5.0%	11.1%	1.5%	6.8%
Energy	-5.1%	-6.9%	-6.3%	-62.1%	-74.6%	249.6%	108.4%	-11.7%	28.1%
Financials	25.1%	11.2%	1.8%	12.6%	1.0%	10.0%	27.1%	8.3%	10.1%
Health Care	5.6%	3.2%	16.2%	9.8%	8.0%	8.4%	15.3%	5.5%	10.1%
Industrials	6.1%	6.9%	12.1%	2.3%	0.3%	4.8%	19.7%	8.8%	11.9%
Information Technology	12.1%	3.2%	6.7%	12.8%	1.0%	21.1%	17.2%	2.5%	11.7%
Materials	-10.1%	3.9%	8.2%	-3.3%	-4.5%	8.0%	21.4%	0.2%	12.3%
Real Estate	11.8%	8.8%	12.0%	5.8%	7.0%	1.4%	7.0%	1.8%	5.8%
Telecom Services	-0.1%	-19.4%	17.2%	7.8%	-2.1%	-15.0%	24.2%	4.3%	11.1%
Utilities	-2.1%	0.7%	2.8%	1.0%	4.7%	-0.4%	4.5%	4.5%	5.9%
S&P 500 Index	**6.5%**	**4.8%**	**6.5%**	**-0.6%**	**1.1%**	**11.5%**	**22.1%**	**4.2%**	**11.4%**

Source: FactSet, 3/31/19

Maintaining Well-Diversified Portfolios, Skewed Toward Leaders in Secular Tech

Based on our expectation that global growth concerns will abate as 2019 progresses, we believe many pro-cyclical sectors offer compelling risk-reward investment opportunities. They encompass a diverse group of industries, including aerospace, semiconductors, oil refiners, chemicals, airlines, life insurance, and investment banks. Many stocks within these sectors are trading at significant discounts to the market average, despite healthy dividends and earnings growth prospects. However, based on the likelihood that "end of cycle" fears will result in continued volatility, we believe it is prudent to balance cyclicals with more stable, secular opportunity growth stocks. Attractive groups in this category include medical devices, pharma/biotech, HMOs, telecom, P&C insurance, and select technology stocks. All portfolios maintain a sizable allocation to the tech sector, with the growth outlook for many tech companies remaining exceptionally strong. Companies in all industries are recognizing secular shifts, which present both challenges and opportunities, and are making significant investments in technology to protect and extend their own business models. This "arms race" is benefiting the semiconductor, systems, and software platform "arms dealers" that enable these changes, and we have invested in many of them. Within global portfolios, we our overweight the U.S. and Asia (ex-Japan), while underweight Europe and Latin America.

Given our somewhat favorable macroeconomic outlook for China and still inexpensive equity valuations, we remain overweight in China. Positive developments in U.S.-China trade negotiations, signs of Chinese policy easing feeding through the credit system, changes in the Federal Reserve's rate hike outlook, and overly pessimistic investment sentiment toward China in 4Q18 are the primary reasons driving the outperformance of the MSCI China Index relative to the MSCI EM Index year to date. We expect "new economy" stocks to perform well given their solid secular fundamentals. However, we are careful not to become too complacent after the strong move of the market and think defensive exposure is also warranted. We are positive on the pharma sector given its positive structural industry growth outlook. While policy headwinds may linger, they are already partially factored into valuations. Overall, we prefer companies with improving fundamentals, secular drivers, strong balance sheets, and reasonable valuation.

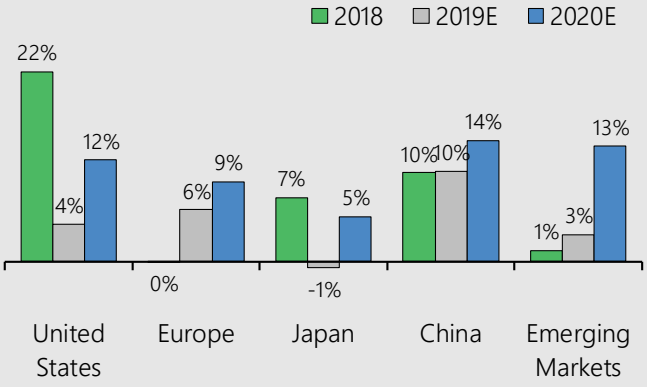
We are also positive on Indian and South Korean equities. In India, Prime Minister Narendra Modi's Bhartiya Janata Party's expected re-election is positive for political stability and his pro-growth economic mandate. As a result, we continue to prefer the consumer, bank, information services, energy, and industrial sectors. Furthermore, the Reserve Bank of India's interest rate cuts will help support economic growth. Market valuations for India remain attractive with the MSCI India Index trading at a 2019 forward price-to-earnings ratio of 17.8 times with 2019 earnings growth of 19 percent. For South Korea, the market is inexpensive, as the MSCI South Korea Index is trading at a 2019 forward price-to-earnings ratio of 11 times with earnings growth decline of -15 percent. However, earnings should improve in the second half of 2019 on recovery in technology, automobile, and consumer companies' results. We like consumer stocks, as earnings should benefit from the higher minimum wage. Additionally, the forthcoming U.S.-China trade deal should be positive for South Korean exporters. We favor a broad-based portfolio of technology, financial, consumer, pharmaceutical, and materials stocks.

The outlook for European stocks remains largely at the mercy of the Brexit outcome, a Chinese economic recovery, and a U.S.-China trade deal. Despite strength in domestic demand and equity valuations that are attractive relative to global peers, these potentially

Global Equites: Notable Data Points

Difficult U.S. Earnings Comparisons in 2019

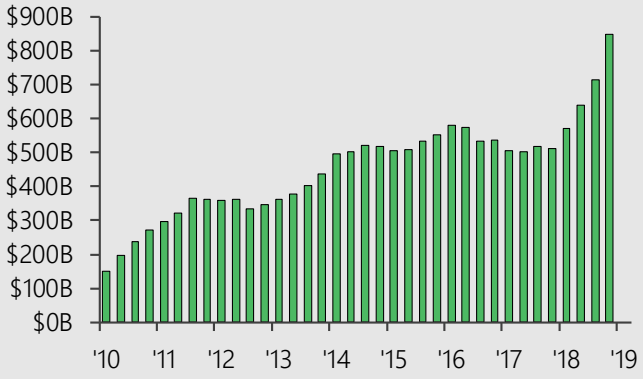
Bottom-Up EPS Estimates for MSCI Indices
Y/Y Percent Change



Source: FactSet, 3/31/19

Continued Buyback Activity Will Buoy EPS

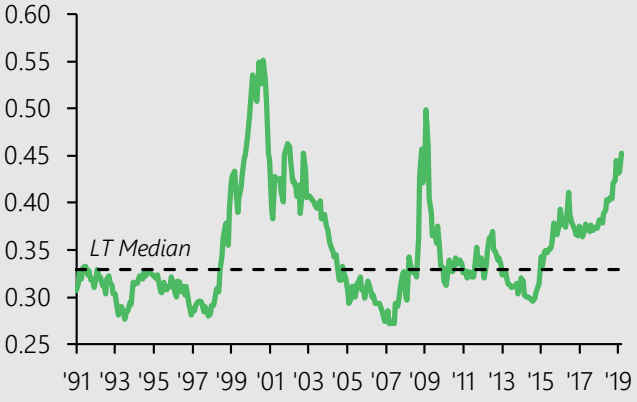
S&P 500 Share Buybacks
Billions of U.S. Dollar, Four-Quarter Sum



Source: FactSet, 3/31/19

P/E Valuation Disparity Near Historical High

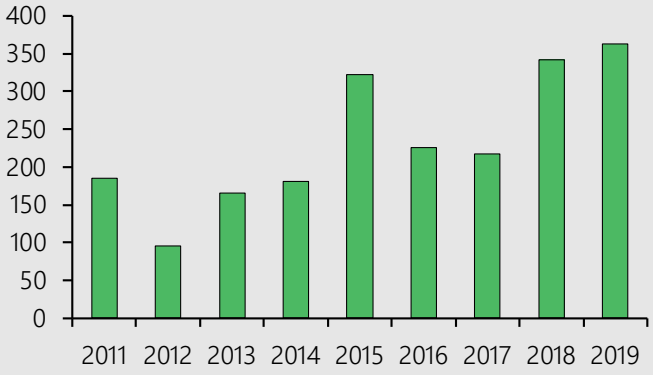
Forward PE Valuation Dispersion of S&P 500 Stocks



Source: BofA/Merrill Lynch, 4/1/2019

Robust M&A Activity Supporting Valuations

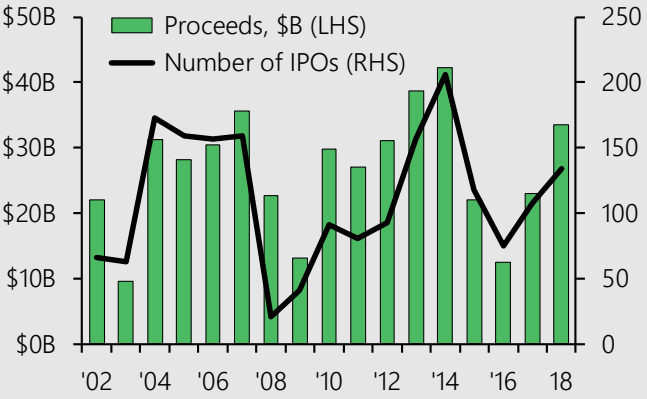
U.S. M&A Transactions, First Quarter
Total Deal Value, $ Billion



Source: MergerMetrics, 3/31/19

Backlog Implies Possible Record IPOs in 2019

U.S. Initial Public Offerings



Source: Warrington College of Business, 12/31/18

Strong Returns Typically Precede Market Peaks

S&P 500	Total Return			% of Cycle Return		
	Months			Months		
Peak	-24	-12	-6	-24	-12	-6
Dec-61	32%	32%	11%	34%	34%	11%
Feb-66	30%	11%	11%	34%	12%	12%
Nov-68	44%	18%	12%	82%	35%	23%
Jan-73	39%	19%	14%	52%	25%	17%
Nov-80	65%	39%	29%	44%	25%	18%
Aug-87	93%	40%	20%	46%	18%	8%
Jul-90	45%	15%	10%	65%	21%	14%
Mar-00	42%	22%	20%	11%	5%	4%
Oct-07	36%	18%	9%	38%	18%	9%
Average	58%	25%	16%	44%	19%	11%
Median	45%	21%	14%	45%	19%	10%

Source: FactSet, 3/31/19

highly impactful uncertainties lead us to remain underweight Europe. While approval of PM Theresa May's Brexit deal would likely result in a rebound in equities, especially for the UK homebuilding, financial, and travel sectors, it is extremely difficult to handicap the outcome given the lack of majority for the current plan or any possible alternative. Despite discounted valuations, we also believe European stocks, in general, do not fully reflect the downside risk of a no-deal Brexit. Consequently, we continue to implement a diversified, barbell strategy focused on less cyclical, developed markets-focused quality growth stocks and beneficiaries of a possible rebound in global trade and a higher fiscal thrust. Portfolios are tilted toward investment opportunities in Euro Area over the UK and those that have underlying niche or secular demand drivers.

We remain underweight Japanese equities as the country's severe structural challenges continue to mute long-term domestic growth prospects. A weakening outlook for growth in the near-term warrants added caution. However, the market incorporates these headwinds to a degree as Japanese equities lagged developed market peers to begin the year and valuations fell near historic lows on a relative basis. Progress in resolving the major uncertainties at present – the U.S.-China trade dispute, slowing growth in China, and the fate of Brexit – could support better returns. Japanese equities could especially benefit relative to others given a higher make-up of cyclically-sensitive sectors. We take this into account with a preference for overseas-exposed names among Japanese holdings. These companies should also benefit from exposure to select faster growing regions of the globe and cost advantage derived from a still-weak yen. We prudently balance this exposure with a mix of defensive consumption holdings, such as health care names, that should perform relatively better in a weak domestic growth environment. Across all holdings, we continue to emphasize high quality names with strong management teams, sound balance sheets, and favorable cash generation characteristics.

In Latin America, we continue to underweight Brazil and Mexico as economic growth is soft and political risks could further impact economic growth. We are cautiously optimistic on Brazil's reform agenda. In Brazil, we like consumer and financial stocks, as retail spending is slowly improving, inflation is falling, and bank credit is rising. Brazil's market valuations are attractive, as the MSCI Brazil Index trades at a 2019 forward price-to-earnings ratio of 11.7 times, an +8 percent premium to its 10-year average with earnings growth of +24 percent. For Mexico, we are negative on the earnings outlook because of slower economic growth from the global economy and higher costs from AMLO's socialist programs (boosting youth employment, higher minimum wages, transfers to the elderly) on the budget. Accordingly, our strategy for Mexico is defensive, focusing on investments in consumer companies with stable/improving earnings. Mexico's market multiple is in-line with its market outlook, as the MSCI Mexico Index trades on a 2019 forward price-to-earnings ratio of 13.1 times, an -18 percent discount to its 10-year average.